Hot Topics in Corporate Governance and Reporting in the UK and US

Dan Hirschovits, Kyoko Takahashi Lin and Fiona Tregeagle

20 June 2019

Davis Polk

Davis Polk & Wardwell London LLP

Today’s speakers

Dan Hirschovits
Partner, London
+44 20 7418 1023
+44 7855 503 165
dan.hirschovits@davispolk.com

Kyoko Lin Takahashi
Partner, New York
+1 212 450 4706
+1 646 221 0094
kyoko.lin@davispolk.com

Fiona Tregeagle
Associate, London
+44 20 7418 1441
+44 7980 770 004
fiona.tregeagle@davispolk.com

Agenda

- Corporate governance reform and reporting requirements in the UK and US
- Pay ratio reporting
- Director 'overboarding'
- Board diversity
- Engagement with stakeholders and employees
- Environmental and Social concerns

Corporate Governance Reform in the UK and US

In the UK:

- New 2018 UK Corporate Governance Code
  - Applies to all companies with a premium listing on the LSE regardless of whether they are incorporated in the UK or elsewhere for financial years beginning on or after 1 January 2019
  - Comply or explain approach
- The Companies (Miscellaneous Reporting) Regulations 2018
  - Applies to financial years beginning on or after 1 January 2019
- BEIS consultation on the FRC replacement, the Audit, Reporting and Governance Authority (ARGA)
  - Consultation closed on 11 June 2019
- New Stewardship Code to be published in summer 2019

In the US:

- There have been few changes on the Federal level under the Trump Administration, but:
  - Some bills have been introduced in Congress
  - Some laws have passed on the US state level

Overview of Key Changes in the UK

2018 UK Corporate Governance Code:

- Stakeholders, board leadership and company purpose
  - Significant votes against shareholder resolutions
  - s. 172 statement included in annual report
  - Workforce and stakeholder engagement
- The boardroom – division of responsibilities, composition, succession and evaluation
  - Directors' time commitments
  - Diversity and succession planning
  - Chair not in post for more than 9 years
  - Additional reporting obligations of the Nomination Committee
- Remuneration
  - RemCom should have at least 12 months experience
  - Broader responsibilities for RemCom to review workforce remuneration

The Regulations:

- For quoted companies:
  - CEO pay ratio reporting
  - Enhanced remuneration reporting
- For "large" companies:
  - s. 172 statement in strategic report
  - Engagement with suppliers, customers and other relevant stakeholders
  - Engagement with employees
  - Corporate governance arrangements statement

Overview of Key Changes in the US

On the Federal Level:

- SEC – regulation agenda includes topics such as:
  - Proxy advisory firm and shareholder proposal submission reform; SEC proposals expected by April 2020
  - Short-term vs. long-termism (i.e., whether to streamline the 10-Q/earnings release process)
- Congressional Bills – some pending including:
  - Cybersecurity – Cybersecurity Disclosure Act of 2019 (S. 592)
    - Would require enhanced disclosure on board cybersecurity experience in SEC filings
  - Board diversity disclosure – Improving Corporate Governance Through Diversity Act of 2019 (S. 360 and H.R.1018)
    - If adopted would require enhanced disclosure on board director and executive officer diversity
  - Bills regarding proxy advisory firm reform and climate risk disclosure – introduced in Congress in the last year, but have not advanced

On the State Level:

- California is leading the charge on environmental and social governance issues
- Board diversity
  - California law (SB-826) mandates female directors on boards of all public companies with principal executive offices in the state as follows:
    - At least one by 31 December 2019
    - At least two by 31 December 2021 for companies with 5 board members
    - At least three by 31 December 2021 for those with 6 or more board members
  - New Jersey proposed a similar bill in 2018
  - Colorado, Illinois, Massachusetts and Pennsylvania have adopted nonbinding resolutions encouraging the same
- Climate change disclosure
  - California law (SB-964) requires its 2 largest pension funds, CalPERS and CalSTRS, to disclose climate change risks by 1 January 2020
    - Together, the 2 funds estimated to have over $400 billion AUM

Hot Topics

PAY RATIO REPORTING

In the UK:

- Required to report the ratio of the CEO's total remuneration to the FTE remuneration of UK employees at 25^{th}, 50^{th} and 75^{th} percentile
- Methodology and presentation prescribed by the Regulations
  - Options A, B or C
  - Nine year look-back
- A number of FTSE 350 companies have already voluntarily disclosed
  - Most have used Option A or indicated they will use Option A
  - For example, AstraZeneca, Marks & Spencer and Unilever
- Links to broader Code provisions on pay

In the US:

- Required to report (i) the median of the annual total compensation of *all* employees, except for the CEO; (ii) the CEO's annual total compensation; and (iii) the ratio of the two amounts
- Methodology and presentation prescribed in Item 402(u) of Regulation S-K
  - Companies have significant flexibility in determining their median employee (e.g., statistical sampling or a consistently applied compensation measure)
  - Generally a company need only identify its median employee once every three years
  - Disclosure is generally required in the company's proxy
- Does not apply to foreign private issuers

Hot Topics
DIRECTOR OVERBOARDING

In the UK:

- Non-executive directors should have sufficient time to meet their board responsibilities
- Prior board approval for external appointments
- 2018 AGM season saw increasing trend of shareholders voting against re-election of a director because of concerns over number of roles
  - For example, Rightmove's chairman and senior independent director
  - Note recent commentary around Sir Nigel Rudd, chair at Meggitt – stepped down as chair of Destiny Pharma in 2018
- Approach of institutional investors and proxy advisers

In the US:

- A typical US director for a public company with few or no issues is estimated to spend more than 250 hours a year alone on board responsibilities
- BlackRock, State Street and Vanguard have strict policies on "overboarded" directors
  - In April 2019, Vanguard updated its policy, capping CEOs and the next 4 highly compensated officers at 2 public boards
- Proxy advisory firms will recommend against "overboarded" directors, for example:
  - ISS policy caps CEOs at 3 boards
  - Glass Lewis policy caps CEOs at 2 boards

See the Appendix for further details on the overboarding policies of institutional investors and proxy advisory firms

Hot Topics

BOARD DIVERSITY

In the UK:

- Boards are encouraged to think broadly about diversity
- Hampton-Alexander Review targets at least 33% of board positions in FTSE 350 held by women by the end of 2020
  - 29% of board positions held by women (up from 12.5% in 2011)
- Parker Review targets at least one director of non-white ethnicity by 2021 for FTSE 100 boards
- Investors have been active in voting against AGM resolutions on the grounds of diversity, particularly lack of gender representation

In the US:

- Topic of considerable focus for US investors, companies, proxy advisory firms and academics
  - Companies are slowly changing
    - Still a large number of Russell 3000 companies that have no female board directors, while 100% of the S&P 100 have had at least one female director
  - Glass Lewis generally recommends a vote against a Nominating Committee chair of a board with no women
  - ISS will enforce the same policy in 2020
- The only SEC guidance this proxy season was on this topic
  - February 2019 staff guidance on enhanced disclosure of board "self-identified" diversity characteristics
    - Definition of diversity covers not only gender and ethnicity/race, but also religion, disability, sexual orientation and cultural background

Hot Topics

EMPLOYEE ENGAGEMENT

In the UK:

- Recommended to use a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director to engage with workforce
- 83% of FTSE 350 companies already disclose some form of employee engagement mechanism
  - Small number of companies already use a designated NED (for example, Rolls-Royce) or workforce advisory panel (for example, Aviva)
  - Others have recently adopted engagement mechanisms for early compliance with the Code (for example, RBS)

In the US:

- No current push to have a director represent the workforce
- Investors and the SEC, however, are increasingly focused on human capital management (HCM), which is broadly defined as workforce retention and talent management
  - BlackRock announced that HCM would be a key corporate engagement topic in 2019
  - The SEC has hosted roundtables on the topic of HCM disclosure requirements

Hot Topics

STAKEHOLDER ENGAGEMENT

In the UK:

- Board should understand views of key stakeholders and describe how their interests and the matters in s172(1) have been considered
  - 11% of FTSE 350 annual reports mention s172 duty (up from 1% of 2016 annual reports)
- 86% of FTSE 350 identify stakeholder groups beyond shareholders
  - 65% disclose methods used to engage with such stakeholders
  - 69% identified stakeholders in a single disclosure only
  - However, increasingly common to include more extensive disclosure (for example, AstraZeneca and Rolls-Royce)

In the US:

- No direct corollary, but some key takeaways
  - US public company issuers tend to view it as *shareholder* engagement (not stakeholder), but there is the increasing focus on community, customer and global impact is gaining traction
  - As for shareholder engagement, US public companies regularly engage with their shareholders proactively as well as reactively, on remuneration, performance and environmental and social topics
    - The larger the company, the more engagement we have seen

Hot Topics

ENVIRONMENTAL AND SOCIAL CONCERNS

In the UK:

- Board should promote the long-term sustainable success and company should contribute to wider society
- New annual streamlined energy and carbon reporting regime (SECR)
- Proposed Stewardship Code refers to ESG factors
  - Signatories are expected to take material ESG issues into account when fulfilling stewardship responsibilities
- Investors lobbying and voting against resolutions (for example, LGIM against Whitbread and Shell)
- BP shareholder resolution on reduction of carbon emissions

In the US:

- As a result of "private ordering"
  - Approximately 86% of S&P 500 companies are now publishing sustainability reports, as compared to ~20% in 2011
- E&S groups are using the shareholder proposal process to have resolutions voted on at annual meetings – most popular topics this proxy season include:
  - Political contributions and lobbying disclosure
  - Climate change issues including linking carbon targets to compensation metrics
- Climate Action 100+, an international group of investors, has extracted significant concessions from companies regarding climate change targets and climate/comp metrics

Appendix

Davis Polk

Investor and Proxy Advisory Firm Priorities

VOTING POLICIES – OVERBOARDING

	Proxy Advisory Firms		Institutional Investors		
	ISS	**Glass Lewis (**)**	**BlackRock**	**State Street**	**Vanguard**
CEO (*)	Capped at **3** public boards	Capped at **2** public boards	Capped at **2** public boards	Capped at **3** public boards	Capped at **2** public boards
Named Executive Officer (*)	No Stated Policy (but by inference capped at **5** public boards)	Capped at **2** public boards	Capped at **4** public boards	Capped at **6** public boards	Capped at **2** public boards
Executive Officer (*)	No Stated Policy (but by inference capped at **5** public boards)	Capped at **2** public boards	Capped at **4** public boards	Capped at **6** public boards	Capped at **4** public boards
Other Directors	Capped at **5** public boards	Capped at **5** public boards	Capped at **4** public boards	Capped at **6** public boards	Capped at **4** public boards

* The number of boards shown in these rows includes the board of the company at which s/he holds such title
** Glass Lewis considers mitigating circumstances

Reporting Requirements under the UK Regulations

	Private companies and public companies that are not quoted				Quoted companies[1]		
	Medium*[2]	Large[3] (250 or fewer UK employees)[4]	Large[3] (more than 250 UK employees)[4]	Very Large[5]	Medium*[2]	Large[3] (250 or fewer UK employees)[4]	Large[3] (more than 250 UK employees)[4]
CEO pay ratio report					X		X
Remuneration reporting					X	X	X
s172(1) statement in strategic report		X	X	X[6]	DTRs / LRs	X	X
S172(1) statement on website		X	X	X			
Stakeholder engagement statement		X	X	X[6]	DTRs / LRs	X	X
Employee engagement statement	X		X	X[7]	X		X
CG arrangements statement (in strategic report and on website)				X	DTRs / LRs	DTRs / LRs	DTRs / LRs

[1] "**Quoted companies**" – UK-incorporated companies that are quoted on the UK Official List, the New York Stock Exchange, NASDAQ or a recognised stock exchange in the EEA. Not AIM traded companies.

[2] "**Medium***" – a company that must produce a strategic report and is not a Large company but has more than 250 UK employees in its group.

[3] "**Large**" – a company that meets two out of three of the following:

- turnover of more than £36 million
- balance sheet total of more than £18 million
- more than 250 employees.

[4] If it is a parent company, it is the number of UK employees in its group.

[5] "**Very Large**" – a company not required to provide a corporate governance statement under DTR 7.2 and having more than 2,000 employees and/or a turnover of more than £200 million and a balance sheet total of more than £2 billion. Quoted companies that are Very Large but are not required to provide a DTR 7.2 statement will need to comply with the CG arrangements statement obligation.

[6] Very Large companies will only have to comply with this requirement if they are also Large.

[7] Very Large companies will only have to comply with this requirement if they have more than 250 UK employees (if the company is a parent company, it is the number of UK employees in its group).